Research Department
Federal Reserve
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FRBSF Weekly Letter

U.S. Recovery

Last year marked the first full year of economic recovery from the deepest recession in the period after the Second World War. Although growth in the first quarter was subpar, robust activity followed through the end of the year. The total value of goods and services produced in the U.S., adjusted for inflation, grew 6.2 percent, or fractionally less than the 6.8 percent first year average of past business cycle upturns.

However, improvement in both employment and inflation was exceptional last year. Civilian employment increased 3.5 percent compared with the average 2.5 percent increase for the first year of a recovery. This increase meant 3.5 million new jobs, or 1 million more than if the improvement had been average. These job gains were reflected in a substantial decline in the unemployment rate from 10.8 percent of the civilian labor force in December 1982 to 8.2 percent a year later.

The extraordinary increase in jobs was accompanied by a further decline in inflation. The average level of prices of all goods and services produced in the U.S., measured by the GNP implicit deflator, increased 4.1 percent over the four quarters of 1983 compared with 4.4 percent in 1982. This improvement was the more remarkable when compared with 1980 and 1981 when inflation averaged 9.4 percent. In short, inflation has been cut by more than half over the past three years. Consumer prices showed even more improvement than the GNP deflator. During 1983, they rose about 3 percent, or less than a third their average rate of increase in 1980 and 1981.

Strengths and weaknesses

A good deal of the economic strength last year was attributable to consumer purchases, particularly of cars and household items. After starting slowly in the first quarter, household spending, adjusted for inflation, increased by 5.2 percent last year, or marginally less than the 5.8 percent average for the first year of previous recoveries. A welcome surprise was the strong pickup in housing and business equipment purchases. By the fourth quarter, residential construction spending was 41 percent above a year earlier, compared with an average first year advance of only 25 percent, and business spending on equipment had increased 20 percent, or more than double the average first year increase of 9.5 percent.

In contrast, both net exports of goods and services and longer-term business spending on structures were weaker in 1983 than is typical for the first year of a recovery. Spending on business structures, adjusted for inflation, usually increases by the final quarter of the first year of recovery. But, by the end of 1983, these expenditures were still 2.5 percent below a year earlier.

By far, the weakest performance in 1983 was in the foreign trade sector. Imports usually rise faster than U.S. exports of goods and services during the first year of recovery because domestic incomes rise faster than incomes abroad. As a result, the difference, or net exports, decreases on average about 50 percent over the first year. Our foreign position, however, deteriorated dramatically last year, with net exports of goods and services falling 73 percent. Actually, U.S. exports increased by $7 billion (in 1972 dollars) in 1983, but U.S. purchases of foreign goods and services increased by $23.5 billion. Together, these produced the dramatic decline in our net export position.

Deficit-induced distortions

The dominance of consumer spending in this recovery, along with the strong growth in housing and business equipment spending, contrasts with the marked weakness in net exports and, to a lesser extent, in busi-

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ness spending on structures. This distorted sectoral growth can in part be traced to the federal government's budget policies, characterized by large deficits. In fiscal 1983, the budget deficit was $195 billion, up substantially from $111 billion in 1982 and more than triple the $58 billion deficit in 1981. A sizeable portion of these deficits is related to the weak state of the economy over the past few years, when we have experienced virtually two back-to-back recessions. During a business downturn, federal tax receipts are weaker than usual while federal outlays increase for cyclically related items, such as high unemployment benefits. These changes in receipts and expenditures mean large budget deficits, which generally set new records in recessions. But even removing the cyclical components, the remaining "structural" deficits, caused by a basic mismatch of tax and spending policies, were historically higher over the past few years and increased from 1.3 percent of GNP in 1981 to 3.1 percent in 1983.

The economic effect of these high and rising structural deficits varies both over time and with the type of budget policies that have led to the deficit. Initially, when an economy is producing at less than full employment, an increase in the structural deficit may increase aggregate spending on goods and services. The increased demand for output and the accompanying demand for transactions, or monetary, balances tends to place upward pressures on interest rates. A reduction in taxes, with no other changes in the fiscal program or in the money supply, adds to households' disposable income. At first, households may increase their spending more than the deficit's adverse effects on interest rates reduce spending. But, as U.S. production increases and the economy operates closer to full employment levels of output, competing demands for available resources will intensify upward pressures on interest rates. Higher interest rates, in turn, lead to the crowding out of some private expenditures until the larger share of GNP is absorbed by the federal deficit.

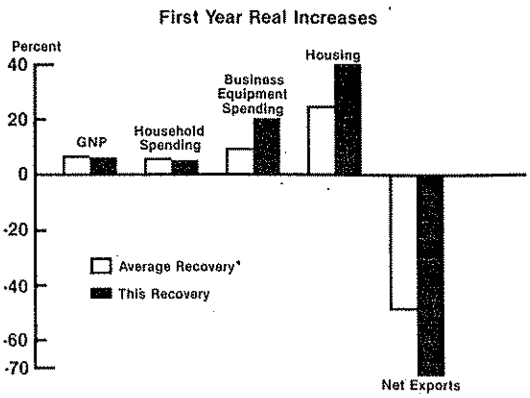
In 1983, we observed some signs of these fiscal effects. Consumer spending was driven in good part by the tax cuts provided in the Economic Recovery Tax Act of 1981. The final 10-percent cut in personal tax rates became effective in mid-1983, and was instrumental in the increase in household spending last year. Similarly, the Tax Act provided business with accelerated depreciation allowances. Once economic conditions began to improve early in 1983, business began an unusual amount of spending on short-lived equipment, taking advantage of this program.

The unusual weakness in 1983 in net exports of goods and services also can be traced to the large deficits. High interest rates here compared to those abroad attract large flows of funds into the U.S. The heavy foreign demand for dollars to be used for investment in our financial markets causes the dollar to rise in value on foreign exchange markets. This higher dollar value means that imports of goods and services are encouraged while the price of our exports is driven up in foreign markets, discouraging U.S. exports. The result is a deterioration in our net foreign position, which reached record proportions in 1983. Thus, in part, the burden of large deficits is being borne by those industries that depend on exports or that compete with imports.

The outlook

The strength in consumer and business spending begun last year is likely to continue in 1984. According to most forecasters, real GNP is expected to increase between 4.0 and 5.0 percent, or slightly above the 3.8 percent average for the second year of recovery. This growth will support further improvement in labor markets. The unemployment rate will likely decline from 8.2 percent in December 1983 (and 8.0 percent in January) to about 7.5 percent in the fourth quarter of 1984.

However, some economic slack is likely to remain this year. Most analysts believe that



*The average includes recoveries from 5 cyclical troughs in 1954.2, 1958.2, 1961.1, 1970.4 and 1975.1. The trough in this recovery is 1982.4.

inflationary pressures do not build until the jobless rate averages around 6.5 percent to 7.0 percent. Consequently, it is likely that inflation this year will remain within the 4.0 percent to 5.0 percent range if there are no surprising changes in energy prices. This inflation range is wide enough to include half of a percentage increase due to hikes in food prices expected to result from last year's severe drought.

According to most forecasts of interest rates, both short- and longer-term rates will remain close, within a half of a percentage point, to their 1983 averages—8.6 percent for the 3-month Treasury Bill rate and 12 percent for the Corporate AAA bond rate. This stability in rates, at fairly high levels this year, contrasts with the substantial reduction in 1983 when both short- and longer-term rates declined between 1.5 and 2.5 percentage points from their average levels in 1982; it is a major reason for the slower real growth expected this year.

The high cost of borrowing is expected to slow substantially the advance in housing, but continued improvement in the job market should allow almost average growth in consumer spending for the second year of recovery, and business spending growth on plant and equipment around the 9.0 percent suggested by recent business plan surveys. However, major weakness is expected to continue in net exports of goods and services largely because of continued high federal budget deficits.

Uncertainties

Uncertainties with regard to this outlook center upon the impact of prospective federal budget deficits and the monetary authorities' reactions to them. Under existing tax laws and spending programs, budget deficits from here on out, by either the current or structural deficit measure, will be large and will represent an increasing share of the national GNP.

Hence, it is clear that the private sector will get a smaller share of income in the 1970s than in prior decades. The displacement of private spending by public deficits has been termed "crowding out," and was clearly observable in 1983 in our net export position. Other interest-sensitive spending, including housing and business expenditures on new plant and equipment, will eventually be noticeably and adversely affected by these large deficits, if they continue. Some market observers fear that the monetary authorities, who have successfully pursued a non-inflationary policy over the past three years, may increase monetary growth in an effort to ease financial market pressures. This would be tantamount to abandoning the fight against inflation. In addition, markets appear dubious about the Administration's and Congress' political will to reduce the budget deficits.

The economic outlook now is one of sustained growth with stable inflation through the end of 1984. Any sign that the monetary authorities have actually deserted their non-inflationary policies, or that pledges to reduce deficits have been rhetorical, will adversely affect this outlook.

Rose McElhattan

BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 2/8/84	Change from 2/1/84	Change from year ago Dollar	Percent
Loans, Leases and Investments[1] [2]	175,109	– 181	2,873	1.7
Loans and Leases[1] [5]	154,755	– 224	4,204	2.8
Commercial and Industrial	45,648	259	– 56	0.0
Real estate	58,942	– 80	1,050	1.8
Loans to Individuals	26,690	35	2,272	9.3
Leases	5,025	6	– 294	– 5.5
U.S. Treasury and Agency Securities[2]	12,234	26	615	5.2
Other Securities[2]	8,120	17	NA	NA
Total Deposits	183,741	–1,567	NA	NA
Demand Deposits	42,162	–1,843	3,377	8.7
Demand Deposits Adjusted[3]	29,507	457	NA	NA
Other Transaction Balances[4]	12,184	125	NA	NA
Total Non-Transaction Balances	129,395	151	NA	NA
Money Market Deposit Accounts—Total	40,009	228	NA	NA
Time Deposits in Amounts of $100,000 or more	38,092	– 71	– 7,828	– 17.0
Other Liabilities for Borrowed Money[5]	18,778	– 821	– 4,382	– 18.9

Weekly Averages of Daily Figures	Week ended 2/8/84	Week ended 2/1/84	Comparable year-ago period
Reserve Position, All Reporting Banks			
Excess Reserves (+)/Deficiency (–)	NA	NA	220
Borrowings	NA	NA	4
Net free reserves (+)/Net borrowed(–)	NA	NA	216

1 Includes loss reserves, unearned income, excludes interbank loans
2 Excludes trading account securities
3 Excludes U.S. government and depository institution deposits and cash items
4 ATS, NOW, Super NOW and savings accounts with telephone transfers
5 Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources
6 Includes items not shown separately

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